

SUMMARY ANALYSIS OF AMENDED BILL

Author: Calderon Analyst: Anne Mazur Bill Number: SB 740
July 5, 2007
 Related Bills: See Prior Analysis Telephone: 845-5404 Amended Date: June 5, 2007
 Attorney: Douglas Powers Sponsor: GE/NBC

SUBJECT: Motion Picture Production Direct Tax Revenue Credit/Sale Of Credits To Unrelated Party/Sales & Use Tax Credit In Lieu Of Income Tax Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED

X February 23, 2007, STILL APPLIES.

X OTHER – See comments below.

SUMMARY

This bill would create a transferable income tax credit based on wages paid and property used in connection with a qualified production made in California.

SUMMARY OF AMENDMENTS

The June 5, 2007, amendments made the following changes:

- Eliminated the commercial production credit.
- Eliminated the refundable feature of the motion picture credit.
- Revised the percentage and basis of credit with reference to "direct tax revenue," as defined.
- Added a provision to allow a corporate taxpayer to assign any portion of the credit to one or more members of its commonly controlled group.
- Added a provision to allow a taxpayer to sell the credit to an unrelated party if attributable to the production of an independent film.
- Revised the operative date.
- Added a provision to allow any unused credit to be carried forward for six years.

Board Position:

_____ S _____ NA _____ NP
 _____ SA _____ O _____ NAR
 _____ N _____ OUA _____ X PENDING

Legislative Director

Date

Brian Putler

7/11/07

The July 5, 2007, amendments would cap the aggregate amount of credit at \$100 million annually, which would be allocated among qualified taxpayers by the California Film Commission (Commission).

The Effective/Operative Date, This Bill, Implementation Considerations, Technical Considerations, Fiscal Impact, Economic Impact, Legal Impact, and Policy Concerns have been revised to reflect the July 5, 2007, and June 5, 2007, amendments and are provided below. The remainder of the department's analysis as amended February 23, 2007, still applies.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The bill specifies that the credit would be operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS

THIS BILL

This bill would create a franchise and income tax credit that would be allocated among qualified taxpayers by the Commission and would not exceed \$100 million in the aggregate annually. The credit amount would be based on direct tax revenues in connection with the production of a motion picture, including television series, in California. The bill would define "direct tax revenues" as the following:

- State income taxes on qualified wages, determined by applying a tax rate of 7 ½ % to such amounts.
- State and local sales and use taxes on qualified taxable property and qualified taxable services, determined by applying the applicable state and local sales and use tax rate to the sales price of such property and services.

The credit amount would be equal to 100% of direct tax revenues if attributable to the production of a qualified motion picture in California, but would equal 125% of direct tax revenues if the qualified motion picture is a television series that relocated to California or an independent film, as those terms are defined in the bill.

The bill would allow the motion picture credit to be claimed against sales or use tax liability in lieu of the franchise or income tax liability. Any such credit remaining would be available for carryover against sales and use tax due for six taxable years. The bill would also allow a qualified taxpayer that is a corporation to elect to assign any portion of the credit to one or more members of its commonly controlled group, as defined. The bill would provide that such election:

- May be based on any method selected by the qualified taxpayer.
- Would be irrevocable for the taxable year the credit is allowed.
- May be changed for any subsequent year if the election is expressly shown on each of the returns of the commonly controlled corporations that assign and receive the credits.

In the alternative, if the credit is attributable to an independent film, as defined, the qualified taxpayer could sell any portion of the credit to an unrelated party. The qualified taxpayer would be required to report to Franchise Tax Board (FTB) prior to the sale of the credit "all required information," as specified by FTB. Credits could not be assigned or sold to more than two successive taxpayers. Credits in excess of tax liability could be carried over for six years.

This bill would require the Business, Transportation and Housing Agency to report to the Legislature by December 31, 2010, on the economic impact of the credit. The bill would authorize this Agency to consult with other organizations and government agencies, including FTB, before completing the report.

The bill also would provide that its provisions are severable if any are invalidated.

The following chart illustrates the criteria for the credit and generally how it would function.

Qualified Motion Picture Credit

Credit Amount – In general, 100% of “direct tax revenues” determined by applying an income tax rate to “qualified wages” and a sales and use tax rate to “qualified property” and “qualified services” during the production period of a “qualified motion picture.” 125% if “TV series relocated to California” or “independent film.” The total amount in the aggregate that can be allocated annually by the Commission is \$100 million.

Qualified Wages – Wages and certain fringe benefits paid or incurred by any taxpayer involved in the production with respect to a qualified individual for services performed on a qualified motion picture in this state.

Qualified Taxable Property – Purchased or leased tangible personal property used in CA in the production of a qualified motion picture.

Qualified Taxable Services – Performed within California in the production of a qualified motion picture.

Designation & Allocation
Taxpayer files verification with Commission to determine and designate qualified taxpayer and allocate credits.

Filming
Taxpayer begins filming within 180 days of designation and must be completed within 30 months of designation.

Copyright
is registered with the US Copyright Office. Such number must be included on the return claiming credit or credit disallowed.

Taxpayer Claims Credit on franchise tax, income tax, or sales tax return, or assigns the credit to member of controlled group. No credit is allowed unless qualified taxpayer substantiates qualified wages were paid in amount claimed and services performed in CA, motion picture was qualified, including identification of qualified individuals, start and end dates of production, total wages paid and amount and type of property purchased, amount of qualified wages paid, and copyright registration number.

Qualified Motion Picture In general.

A motion picture produced for distribution to the general public and at least 75% of total production days on or after 1/1/08 occur wholly in California.

Budget requirements. A **feature film** qualifies if it has a minimum budget of \$1 million and a maximum budget of \$75 million. A **movie of the week or miniseries** qualifies if it has a minimum budget of \$500,000.

Also qualifying, a **TV series** new to CA, with a minimum budget of \$1 million licensed for original distribution on basis cable; an **independent film** with a **minimum budget of \$1 million** and maximum budget of \$10 million produced by company that is not publicly traded and is not more than 25% owned by publicly traded companies; and a **TV series that relocated to CA, without regard to episode length** that filmed all prior seasons outside of CA and certifies that the credit is the primary reason for relocating to CA.

“Qualified motion picture” would exclude any of the following:

- Commercial advertising.
- Music videos.
- Motion picture produced:
 - for private noncommercial use, such as weddings or graduations, or
 - by students made as part of any educational course.
- News program, current events or public events program, talk show, game show, sporting event, or awards show.
- Telethon or other production that solicits funds.
- Reality television program.
- Clip-based programming if more than 50% of the content is comprised of licensed footage.
- Documentary.
- Variety program.
- Daytime drama.
- Strip show.
- One-half hour (air time) episodic television show.
- Any production that falls within the recordkeeping requirements of Section 2257 of Title 18 of the U.S. Code.

“Qualified wages” would exclude any of the following:

- Expenses, including wages, related to new use, reuse, clip use, licensing, secondary markets, or residual compensation, or the creation of any ancillary product, including, but not limited to, a soundtrack album, toy, game, trailer, or teaser.
- Expenses, including wages, paid or incurred with respect to acquisition, development, turnaround, or any rights thereto.
- Expenses, including wages, related to financing, overhead, marketing, promotion, or distribution of a qualified motion picture.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation concerns. Additional concerns may be identified as the bill moves through the legislative process. Department staff is available to assist in the resolution of these concerns.

1. This bill would authorize the Commission to allocate the credit to designated taxpayers. The bill also requires the qualified taxpayer to substantiate both the qualified wages and that the picture is a qualified motion picture or the credit would be disallowed; however, it is not clear whether this substantiation is made to the Commission or to FTB.

2. The bill appears to contemplate an FTB audit presence, but it is not clear from the language of the bill whether the results of an FTB audit could reduce an amount of credit allocated by the Commission. Staff recommends that the bill be amended to authorize the Commission to make a final certification of a qualified taxpayer and the amount of credit allowed to each, and to notify the qualified taxpayer, FTB, and Board of Equalization (BOE) of such final certifications on annual basis.

Alternatively, if the author intends that FTB audit this credit, then the allocation rules should make it clear that the Commission's allocation is tentative, subject to adjustment as a result of final FTB audit results of the enumerated substantiation issues (and any applicable administrative or judicial proceedings resulting from that adjustment).

3. This bill allows the Corporation Tax Law (CTL) credit to be assigned to any member of a commonly controlled group. It is unclear what limitations, if any, would be applicable regarding this assignment among members of a commonly controlled group.
 - It is unclear what would happen if a taxpayer assigns a credit and the credit is partially or completely disallowed in a subsequent audit by the department. The bill should clarify the department's legal authority to adjust the tax liability of the assignee (or purchaser) and reclaim the credit amount, with interest, from the assignee, especially if the assignor (or seller) is either no longer in existence or no longer subject to California's taxing jurisdiction.
 - Because there may be occasion where the department's audit of the assignor taxpayer's return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it might become necessary for the department to request waiver of the assignee's (or purchaser's) statute of limitations to prevent the department from being foreclosed from adjusting the assignee's tax liability when the department determines that part or all of the claimed credit should never have been allowed.
 - The department would need to be specifically authorized to disclose the necessary confidential tax information of the assignor to the assignee if such an audit situation.
 - The assignee would statutorily need authorization to obtain tax information from the assignor about the circumstances surrounding the credit that was assigned in order to defend a subsequent proposed adjustment by the department.
 - If the credit is disallowed only in part upon FTB audit, it is unclear how this disallowance would be allocated between the assignor and the assignee, particularly if the statute of limitations has expired for one, but not both, of the affected taxpayers. These issues would apply as well for credits that are sold.
 - The bill does not specify when the assignee taxpayer can use the assigned credit. It could be used in the same year as the assignor earned the credit or it could be used in the taxable year succeeding the taxable year of assignment and subsequent taxable years, similar to a carryover. In addition, it is unclear what the applicable carry forward period would be for an assigned credit, as well as for credits that are sold.

4. A commonly controlled group is not necessarily the same as a unitary group if the tests of unity are not satisfied during the year. The bill does not specify how the assignment would occur in this case.

In addition, the bill does not specify what would happen if a member subsequently entered or left the group.

5. The mechanics of the election to assign the credit should be developed to require a formal election on a timely filed original return and a system to notify FTB in the form and manner prescribed by FTB in forms and instructions.
6. The bill states that where the credit exceeds the qualified taxpayer's tax liability, the taxpayer may elect to assign any portion of the credit allowed. This suggests that any or all of the allowed credit could be assigned, not just the amount in excess of the qualified taxpayer's tax liability. This bill should clarify the amount available for assignment.
7. Copyright registration number and "qualified taxpayer" designation verification when processing returns claiming the credit would result in a new manual workload.
8. The bill would allow the credit earned under the income or franchise tax laws to be used, by either the taxpayer earning the credit or an assignee of that taxpayer, to offset liability under the Sales and Use Tax Law. This provision would substantially complicate administration and potentially confuse taxpayers. For example, although the bill language states that the BOE would generally have three years to recover an "erroneous" credit or refund, FTB normally has a four-year time period for making deficiency assessments under the Personal Income and Corporation Tax laws (PITL and CTL), and the bill is silent as to which statute of limitations would be applicable.

The mechanics of the election should be refined to require a formal election on a timely filed original return in the form and manner prescribed by FTB in forms and instructions.

In addition, the language of the bill would require the qualified taxpayer to make an irrevocable election under this sales and use tax (SUT) provision, but does not make such a requirement for a member of the taxpayer's controlled group that has been assigned the credit.

9. This bill would allow a qualified taxpayer to make an irrevocable election to claim this credit against sales and use tax liability. The language would be subject to the argument that it allows claims for credit of SUT based on an amount of credit that is in excess of the franchise tax liability. Department staff suggests the bill be amended to clarify that a taxpayer may not claim credits against both SUT or franchise and income tax, or make an otherwise nonrefundable credit, refundable. Department staff also suggests the bill be amended to provide that the refund allowed under the SUT in-lieu election may not exceed the taxpayer's "net tax" or "tax."

10. In defining a “qualified motion picture,” the bill states that, in computing total wages paid or incurred for the production of a qualified motion picture, all amounts paid or incurred by all persons or entities that share in the costs of the qualified motion picture shall be *aggregated*. Aggregation language appears to contemplate various persons paying wages in connection with the production of a motion picture. This seems to conflict with the fundamental definition of a “qualified taxpayer” as being that taxpayer who has paid or incurred the expenses for the qualified amount.
11. The definition of “qualified motion picture” uses the phrase “new to California.” The meaning of this phrase should be clarified.
12. The definition of “qualified motion picture” would require at least 75% of the “total production days” to occur wholly within California on or after January 1, 2008, or 75% of the use of the total production budget occurs within California. Staff notes the following concerns with this requirement:
 - With respect to “total production days,” department staff assumes this means a California production day is a day of production occurring entirely in California and that at least 75% of all production days must be California production days. If staff's understanding of the author's intent on this point is correct, then the bill should be clarified accordingly.
 - The bill does not define “production” day. It is not clear whether such “production” would include only principal photography, or whether it also would include preproduction and postproduction.
 - Department staff suggests defining the term “total production budget” as well as the concept “use of total production occurs within California.”
 - There is no time restriction imposed for use of the production budget similar to the time restriction on production days. Staff suggests the bill be amended to clarify whether the January 1, 2008, time threshold applies to both terms.
13. The bill states that property is qualified if it is used within California in the production of a qualified motion picture. The bill does not provide a standard or minimum amount of “use” that is required. Department staff recommends the term “use” be clearly defined to avoid disputes regarding how much use would be required. The definition could be based, for example, on the percentage of time the property is used in the production of a qualified motion picture.
14. The bill states that the credit would be denied unless the taxpayer substantiates by adequate books and records that the wages were paid in the amount claimed and that the motion picture was a qualified motion picture. There is no comparable substantiation requirement for amounts paid to purchase or lease qualified property or qualified services. In any event, amounts paid should be reflected in the production entity's properly maintained books and records. Department staff recommends that the substantiation standards included in the bill be deleted because a general substantiation requirement already exists in current law. Inclusion of such standards in the bill might suggest that the standard for this credit is different than the general requirement.

15. The bill would define “qualified services” as services performed within California in the production of a qualified motion picture. For purposes of computing “direct tax revenue,” the bill would apply a sales or use tax rate to qualified services. Because the bill also specifies that payments to independent contractors would be treated as wages, it is unclear how payments for qualified services are to be distinguished from payments treated as qualified wages. Moreover, payments for services are generally exempt from sales and use taxes.
16. Various film industry terms are used throughout this bill without definition, such as “production period” or “principal photography.” Department staff recommends that these terms be clearly defined to simplify administration and avoid disputes.
17. The bill does not require the Commission to provide FTB with a list of taxpayers designated by the Commission as “qualified taxpayers.” This list would be necessary for FTB to verify that the taxpayer claiming the credit (or assigning or selling the credit) was a qualified taxpayer.
18. The bill states that the credit could not be assigned or sold to more than two successive taxpayers. It is unclear how the term “successive” would be applied. Staff suggests the bill be amended to clarify the intention for this provision.
19. It is unclear whether there would be any separate tax consequences for the assignment or sale of the credit, such as recognition of income to seller/assignor or assignee/purchaser or a required basis computation.

TECHNICAL CONSIDERATIONS

1. The language of the bill regarding assignment of the credit to one or more members of a commonly controlled group makes an erroneous reference. The provision attempts to override credit rules for passthrough business entities, which are in Revenue and Taxation Code (R&TC) section 23036(j), but instead references 23036(i), relating to credit limitations for disregarded entities. To correct this reference, on page 18, line 34, “subdivision (i)” should be replaced with “subdivision (j)” in lieu thereof.
2. The term “taxable years” is used in reference to carryovers of excess credit in the SUT portion of the bill. However, it is unclear whether such a term is valid for that purpose under the SUT law.
3. It appears the intention of this bill is to allow the credit only at the shareholder level and not to allow an S corporation to reduce entity level tax by any portion of such credit. The bill, however, would deny the credit to an S corporation only for taxes imposed under Chapter 4.5 (commencing with R&TC section 23800). Pursuant to section 23802, an S corporation is subject to the tax imposed under Chapter 2 (section 23101) and Chapter 3 (23501), but at a reduced rate (i.e., the 1 ½% entity-level tax). Chapter 4.5 only imposes the built-in gains tax and the tax on passive income. If the intent is to prohibit an S corporation from using the credit against any of those taxes, including the 1 ½ % tax, the reference should be corrected accordingly.

4. A portion of the amount of the credit would be an amount equal to an approximation of the sales and use tax on qualified taxable property and qualified taxable services used in a qualified production; however, there is no requirement that the qualified taxpayer actually pay sales and use tax on the purchase or lease of the property or services. Staff recommends the bill be amended to add such a requirement.
5. On page 11, line 22 and page 20, line 9, strikeout “if” and insert “of” in lieu thereof.
6. On page 15, line 33, strikeout “television series” and insert “film” in lieu thereof.

FISCAL IMPACT

The department’s costs to administer this bill cannot be determined until implementation concerns have been resolved, but are anticipated to be significant relating to manual processing—if the department is required to verify copyright registration numbers or otherwise validate the credit during the initial processing of tax returns claiming the credit—and audit activity to verify eligibility of the taxpayer claiming the credit and correctness of credit amount claimed. The costs to conduct such lengthy and complex audits would be substantial.

It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which will delay implementation of this bill.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses:

Estimated Revenue Impact of SB 740 Effective for Tax Years BOA 1/1/2008 Assumed Enactment Date After 6/30/2007 (\$ in Millions)		
2007/08	2008/09	2009/10
- \$5	- \$80	- \$110

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of the motion picture production credit is dependent on the amount of qualified wages and qualified tangible personal property purchased or leased, and the portion of the allocated credit that is used to reduce tax liabilities.

Based on employment data for the film/video production industry in California and adjusting for tangible personal property, total credits for qualified wages and property are anticipated to exceed the annual aggregate credit cap of \$100 million.

The \$100 million of allocated credits are adjusted for the following reasons:

- 1) Projects that are approved for credit allocation in 2008, but for which the project is not completed by the end of 2008, and
- 2) Projects that are approved by the Commission but are later abandoned and therefore ineligible for credit allotments initially assigned.

Credits generated for the 2008 taxable year are projected to be \$72 million derived as follows:

$\$100 \text{ million in credits} \times 75\% \text{ (percentage of films that are allocated a credit for 2008 and are completed before the end of 2008)} \times 96\% \text{ (1 - 4\%, percentage of films for which a credit is allocated in 2008, but is subsequently abandoned prior to completion)} = \72 million.

Unused credits may be assigned to members of a corporate qualified taxpayer's commonly controlled group and or sold by independent film producers (as defined) to other taxpayers. Therefore, it is assumed that of the \$72 million in credits generated during 2008, on average, taxpayers will use 77% or \$55 million of these credits. It is assumed that carryover credits will be used, on average, over two years.

Total credits generated are adjusted to reflect a usage pattern on a fiscal year basis. To allow time for the Commission to establish a new approval process, a portion of the revenue impact for fiscal year 2007/2008 (which reflects only six months) is shifted to fiscal year 2008/2009.

LEGAL IMPACT

This bill would require taxpayers to perform activities in the state to qualify for the credit. This requirement may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

ARGUMENTS/POLICY CONCERNS

1. This bill would allow the credit to be used by any member of a commonly-controlled group, irrespective of whether that group is a unitary group. Currently, only the low-income housing credit permits a corporation to assign all or a portion of its low-income housing credit to one or more affiliated corporations and only under very narrow circumstances --100% common ownership is required. There is otherwise no precedent for a franchise or income tax law that would allow a credit to be used by taxpayers with no economic responsibility for the expenses that provided the basis for that credit.
2. It may be more cost efficient and simpler for the department to administer a refundable income tax credit rather than a credit that can be assigned or sold to another taxpayer or applied against sales or use tax. However, refundable credits historically have been susceptible to fraud.
3. This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.
4. Conflicting tax policies come into play when a credit is provided for an expense item for which preferential treatment is already allowed in the form of an expense deduction. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item. On the other hand, making an adjustment to reduce basis in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy. In the case of a one-time business expense deduction, the reduction of that expense by the amount of the credit would not create an ongoing depreciation difference.
5. This bill would apply for taxable years beginning on or after January 1, 2008; however, there is no language in the bill that would prevent the credit from being based on amounts incurred—wages paid or property purchased or leased—prior to that date or prior to the date the taxpayer is designated as qualified by the Commission.

LEGISLATIVE STAFF CONTACT

Anne Mazur
Franchise Tax Board
(916) 845-5404
anne.mazur@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov